The *Real Estate Outlook* features a monthly summary of current economic conditions, an easy-to-read forecast for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the Nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets. If you would like to subscribe to the *Real Estate Outlook*, contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

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REAL ESTATE OUTLOOK

Vol. 4, No. 2 February 1991

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- After several quarters of below-average growth, the economy contracted at a 2.1 percent annual rate in the final quarter of 1990. The recession is likely to be mild relative to past downturns, thanks in part to declining interest rates and better control of inventories and inflation. While many questions remain -- particularly about the war's effect on the economy via oil prices and consumer confidence -- most of the evidence suggests a turnaround at mid-year.
- The Federal Reserve has eased monetary policy in the past few months, but lethargic money supply growth suggests that the stimulus is not carrying as much punch, perhaps due to banks' increased reluctance to make loans. Federal Reserve Chairman Alan Greenspan has testified recently that the central bank is concerned with the money supply's low growth, suggesting that further easing may be imminent.
- A sharp 12.4 percent decline in December's housing starts signals continued weakness in the housing markets. The loss was accounted for by the annual pace of multi-family housing starts, which fell from 359,000 units in November to 232,000 in December. While the Midwest experienced a modest decline, the other three regions recorded double-digit declines in December.
- The new home sales rate remained below the half-million mark during the last three months of 1990. In December, new home sales dropped 6.7 percent from November's level and 27 percent from the level a year earlier. The West was the only region to show positive growth in each month of the fourth quarter. All four regions experienced double-digit declines in new home sales in 1990 from the year before.
- The median price of existing homes broke its string of four consecutive declines by growing a scant 0.1 percent in December. After showing no change in November, the median price for new homes jumped 10.8 percent in December; some retreat from the month's median price of $133,000 is projected in the coming months. December marked the fifth consecutive month that average prices of existing homes fell, dropping 1.3 percent. The average price of new homes, like median prices, increased dramatically by 12.2 percent.

IN THIS ISSUE

NATIONAL ASSOCIATION OF REALTORS®
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What Did You Know, and When Did You Know It?

by John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

When I think back on all the crap
I learned in high school,
It's a wonder I can think at all.

Few of us could avoid being riveted to our TV screens on January 17 and 18; some of us still can't. Despite anticipation, despite media buildup, we were still stunned by war live in our living rooms. The immediacy of conflict was both horrifying and attractive, with emotions ranging from fear for the safety of our troops to curiosity over the video-game quality of aerial combat.

Yet, the more we watched, the less we knew. The bits, pieces and factoids of the war as presented by CNN added up to nothing more than confusing. Information, paradoxically, reduced understanding. And that's a lesson we need to learn in this so-called "information age." It's not how much information you have, it's how well you process and assimilate that information. We will eventually sort out truth and fiction in the desert, but it will take time, patience and wisdom.

The coverage of the war has also shown us something else. The precision of our weapons systems--even the live transmission of pictures of that precision--has impressed on the American public as nothing else the degree to which technology has come to dominate our lives. We have more information, and our economy has adopted information as a basic currency, to a great degree because we have the devices to organize it. So much of what we produce, and the manner in which we produce it, is controlled by mechanisms which did not exist a decade ago, and whose impact we only vaguely understand.

Let's take one very mundane example and illustrate this. Ten years ago, we heard only futuristic references to a system of computerized pricing that would speed retail purchases. Now, we think nothing of a supermarket clerk passing our goods over a scanning device that feeds information to the cash register. The development of Universal Bar Codes (UBC) and optical scanning technology has increased efficiency (even though we're still left with the nagging suspicion that we're being overcharged).

But it's also caused a change in the competitive relationship between manufacturers and retailers by organizing information. Prior to the advent of UBC, manufacturers could both create demand by advertising and create supply by dictating store policies. They could do so because they controlled more information than did the retailer. The UBC system allows the merchant to track more closely product flow and thus allocate (often by charging producers premiums) scarce shelf space. In short, a shift in the balance of information represents a shift in the balance of market power.

This is a small example of the changes that have taken place not only in the American economy, but also in the world economy. Part of the reason for the rise of Japan as a world economic power is the care with which the Japanese accumulate and organize information. The edge in this type of economic system goes to those who can most effectively blend available information and the technology that makes it productive. That's the real meaning of "information age."

The changes that have occurred in the past decade are also part of the reason why the current economy is so difficult to call. So many of our economic models are based on the relationships of the past, and so many of these relationships have been fundamentally altered, that the tea leaves are hard to read. Economists point to past business cycles and predict a long recession; others cite leaner business inventories as a sign that the recession will be short.

The fact is that none of our models has yet captured the role of information and its organization in the economy. Without that, we fly by the seat of our pants. Perhaps the key input to any economic forecast is an analysis of the information that the public receives on the economy and on the war.

The real estate business has been affected more than most by the shift to an information-based economy. This is not surprising since real estate is basically an industry that deals with people and information. The change has occurred from two sides. On the people side, the customers with which we deal have become more sophisticated and have come to expect more in the way of information and service. They expect the Realtor to be competitive in the presentation of information with the electronic and print media. And just as younger audiences are more comfortable with CNN's war coverage, so too are they more demanding of real estate professionals.

On the business side the advent of computerized MLS systems have increased the information flow, and now computerized loan origination networks will link the transaction and financing pieces of the real estate deal much more closely. From there, it's a very small step to the integration of all elements of the process.

All the changes that are occurring in the economy and in the business add up to a significant challenge for both. The effective and productive use of information will be the key to economic success. But getting there will require investment in technological development, equipment and, most importantly, education. The required mix not only uses information and the mechanisms to process it, but also the people who understand -- not just know, but understand.

We've all been impressed by the dividends that technological research and information organization have produced in the military. Now we need to translate those lessons into all the other areas of our collective life.

But my lack of education hasn't hurt me none,
'Cause I can read the writing on the wall.

Outlook for the Economy and Real Estate

Like the Gulf war, it seemed that the recession might be over before it had hardly begun. But, like the Gulf war, the initial optimism has been tempered, and a quick and easy end appears elusive. While it has ceded center stage to the war, the recession is very much with us. Output fell an annualized 2.1 percent in the final quarter of 1990 and should fall another 1.8 percent in 1991's first quarter. The following quarter should see a minor contraction of 0.5 percent before summer brings us economic recovery.

Yet the recession is still likely to be mild relative to past downturns. Interest rates have been heading down, inventories remain in control, and inflation is much better behaved than it was at the beginning of the last recession. While many questions remain -- particularly about the war's effect on the economy via oil prices and consumer confidence -- most of the evidence suggests a turnaround at mid-year. For all of 1991, the economy is expected to contract by 0.2 percent, and 1992 should see growth of 2.7 percent.

Economists Had Their Own Punxsutawney Phil

Like the groundhog who signals the coming of spring, the employment report in early February was widely anticipated as a gauge of the recession's grip on the economy. Bouyed by the unexpected strength in the GNP numbers released the week before, many economists hoped that a thaw might be evident. But the shadows cast by the employment figures scared off much of the newfound optimism, suggesting several more months of recession.

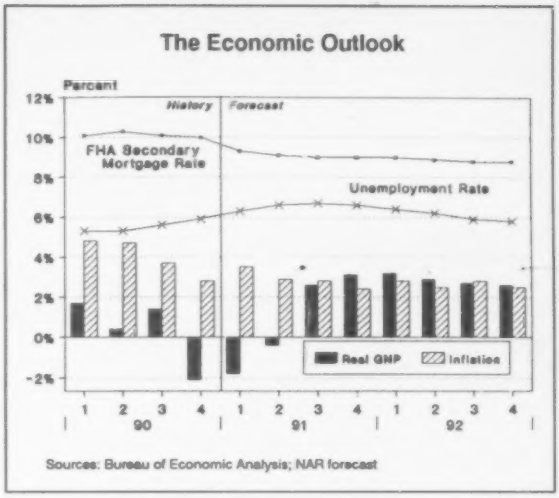
The employment report showed that the unemployment rate crept up another notch to 6.2% in January, a full point above its level just seven months earlier. Meanwhile, payrolls fell by 232,000 jobs, and revisions doubled December's original estimate of job losses to 148,000. Given that these figures are already seasonally adjusted, the usual declines in employment due to seasonal variations (for example, in retail and construction) can't explain the sharp drop. What can explain it is a faltering economy.

Further evidence of the troubled economy comes from the industrial production report. In the final quarter of 1990, output at the nation's factories, mines and utilities fell at a 12.1 percent annual rate. Production of autos and related equipment nose-dived at a 62.7 percent annual rate. With further cuts in automobile production already announced for the current quarter, industrial production is not expected to rebound until spring.

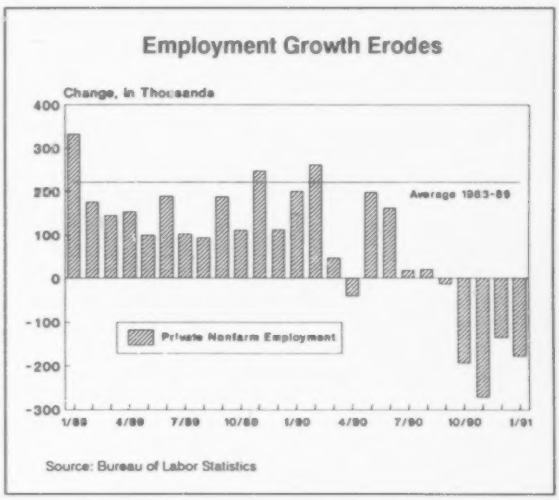
Modest GNP Decline in Fourth Quarter

The fourth-quarter GNP numbers were widely expected to show a sharp decline, perhaps in excess of 3.5 percent. The fact that the figure showed a decline of only 2.1 percent was taken as good news -- the economy was in better shape than had been thought. Inventories fell during the quarter, instead of stacking up as is usually the case early in recessions. This implies that businesses in general will be under less pressure to slash production over the next few months.

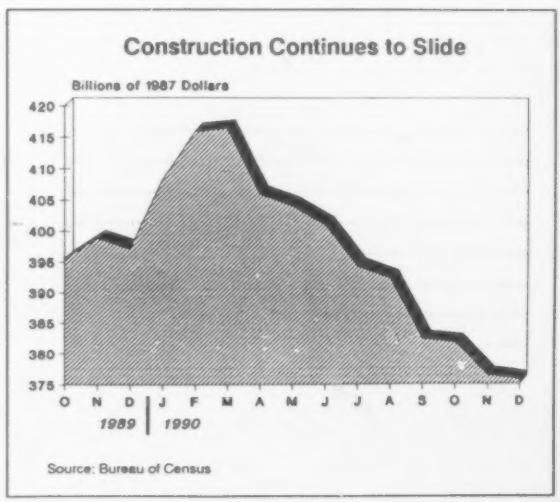
Spending by anxious consumers in the fourth quarter fell at a 3.1 percent annual rate, in line with expectations. With consumer confidence still low, another, though more modest, decline is expected in the current quarter.



Sources: Bureau of Economic Analysis; NAR forecast



Source: Bureau of Labor Statistics



Source: Bureau of Census

The Fed Acts to Fight Recession

Short-term rates are more strongly influenced by the Federal Reserve's monetary policy, and these rates have been falling substantially. The chart at right shows the interest rate on federal funds, which banks loan overnight among themselves. The Fed has targeted the interest rate in the federal funds market to 6.25 percent, two percentage points lower than it was in the fall. The most recent cut in the target rate came within an hour of the release of January's poor employment figures on February 1.

But so far the Fed's easing has been running into the brick wall of the credit crunch, as shown by the recent lack of growth in the money suppply. Normally, an increase in credit by the Fed provides more funds for banks to lend, and the banks generally lower rates to attract new customers. When made, the loans become additions to the money supply. But now, with banks using the funds to improve their capital ratios and businesses and consumers holding back on borrowing, new loans are not being made as quickly. Consequently, even though rates have fallen, money supply growth remains low. Fed Chairman Alan Greenspan has testified recently that the central bank is determined to spur money supply growth, indicating that further ease in monetary policy may be forthcoming if money supply growth continues to languish.

The Outbreak of War

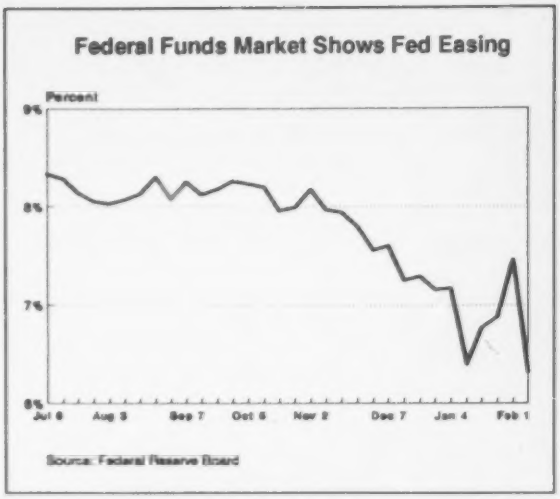
In recent months, most baseline economic forecasts handled the Persian Gulf standoff by assuming a diplomatic solution or, at worst, a quick and decisive Allied victory. If a shooting war broke out, according to most projections, interest rates and oil prices would rise, [illegible] the recession longer and deeper. As it turned ou[illegible] projections were correct -- for about four hours [illegible]e movements in the market were as expected, but instead of covering weeks or maybe months, it covered only hours.

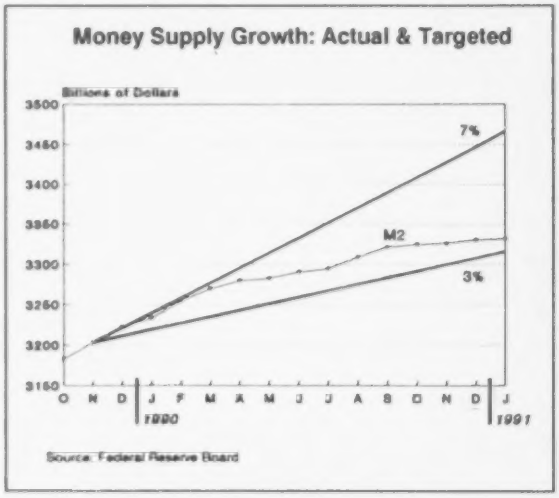
This surprising compactness of events resulted from the overwhelming success of the Allied bombing raids on the night of January 16. As the weakness of the Iraqi response became clear, world markets felt relief. Damage to Saudi oil facilities seemed much less likely, as did a protracted, bloody ground war. Oil prices fell overnight by $10 to $15 per barrel, depending upon grade. As the high uncertainty over the Gulf situation dropped a notch, interest rates dropped.

Less Inflation Leads to Lower Rates

Besides the lessened anxiety over the war, other influences have pushed interest rates down. Lower oil prices suggest lower inflation, scaling back the inflationary premium on long-term interest rates. Since recessions tend to lower the inflation rate, this inflationary expectation component of rates has also been trimmed over the past few months as the certainty of recession increased.

Despite the flare-up in oil prices, inflation is a bright spot in the outlook. In the fourth quarter of 1991, consumer prices rose at a 6.9 percent annual rate, which seems restrained in the face of the third quarter's oil shock. Inflation is projected at 4.5 percent in 1991 and at 3.5 percent in 1992, almost two percentage points lower than 1990's rate.





Housing Starts

(Seasonally Adjusted Annual Rates, in Thousands)

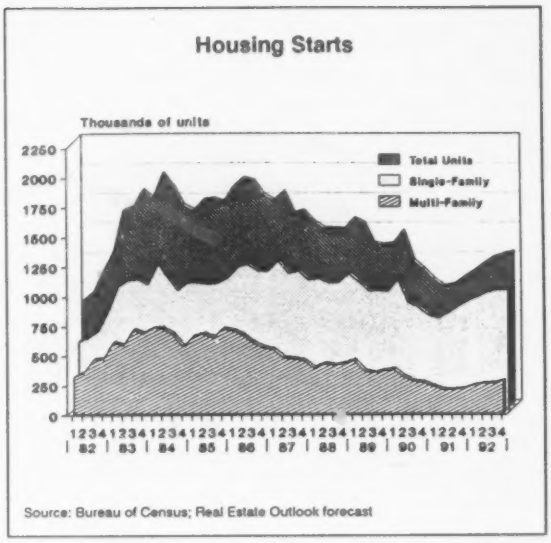
National Data

	Total	SF	2-4	5+
Dec 1989	1,273	931	53	289
Aug 1990	1,131	836	30	265
Sep 1990	1,106	859	34	213
Oct 1990	1,026	839	22	165
Nov 1990	1,127	768	44	315
Dec 1990	***987***	***755***	***19***	***213***
Annual Averages:				
1989	1,386	1,010	55	321
1990	1,209	905	37	267
Percent Changes in December 1990 since:				
Dec 1989	-22.5	-18.9	-64.2	-26.3
Nov 1990	-12.4	-1.7	-56.8	-32.4

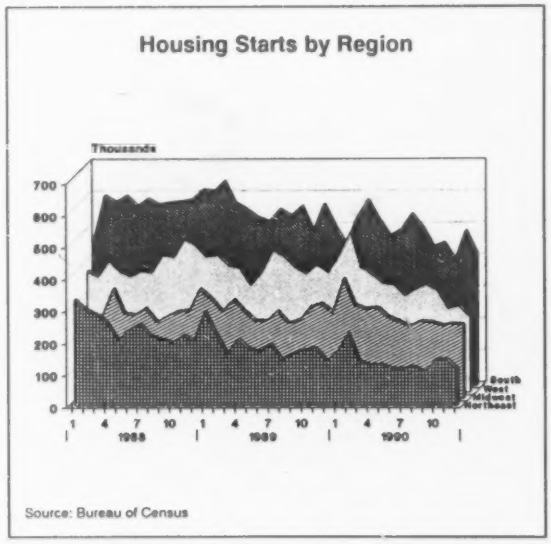
Regional Data

	Northeast	Midwest	South	West
Dec 1989	138	267	440	428
Aug 1990	120	241	434	336
Sep 1990	104	239	445	318
Oct 1990	144	229	393	260
Nov 1990	142	234	482	269
Dec 1990	***112***	***231***	***409***	***235***
Annual Averages:				
1989	183	270	536	397
1990	136	261	481	331
Percent Changes in December 1990 since:				
Dec 1989	-18.8	-13.5	-7.0	-45.1
Nov 1990	-21.1	-1.3	-15.1	-12.6

Source: Bureau of Census, Construction Reports, Series C25



Source: Bureau of Census; Real Estate Outlook forecast



Source: Bureau of Census

A sharp 12.4 percent decline in December's housing starts signals continued weakness in the housing markets and the economy as a whole. The annual rate of 987,000 units is 22.5 percent below the rate recorded in December of 1989, and the levels reached during the fourth quarter of 1990 are the lowest since the end of the last recession in October 1982. Relative to 1989, the pace of housing starts in 1990 was down 12.8 percent. Single-family starts were down 10.3 percent; multi-family starts were down 20 percent.

All of December's loss was accounted for by multi-family housing starts. The rate of multi-family starts fell from 359,000 units in November to 232,000 units in December. As evidenced by the monthly data, multi-family housing starts were quite volatile during the fourth quarter of 1990. Overall, multi-family housing starts averaged 259,000 units during the fourth quarter of 1990, 5 percent below the third quarter's level.

While the Midwest experienced a modest decline, the other three regions recorded double-digit declines in December. The Northeast saw the largest decline, dropping 21 percent from November.

Housing starts are expected to reach bottom during the first quarter of 1991, when they are projected to average 988,000 units. By the second half of 1991, a recovering economy and lower mortgage rates will spur home building, and healthy gains in 1992 are expected as well.

New Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

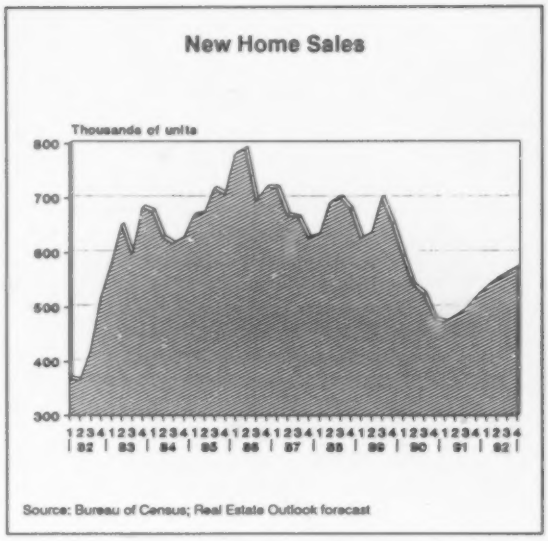
National Data

		Mo. Ago % Chg.	Yr. Ago % Chg.
Dec 1989	633	-7.9	-5.4
Jan 1990	613	-3.2	-12.9
Feb 1990	606	-1.1	-2.7
Mar 1990	558	-7.9	0.4
Apr 1990	533	-4.5	-12.6
May 1990	536	0.6	-17.7
Jun 1990	550	2.6	-14.9
Jul 1990	541	-1.6	-27.0
Aug 1990	527	-2.6	-26.7
Sep 1990	505	-4.2	-20.8
Oct 1990	475	-5.9	-25.3
Nov 1990	496	4.4	-27.8
Dec 1990	***463***	-6.7	-26.9
Annual Averages:			
1989	654		[illegible]
1990	534		-18.3

Regional Data

	Northeast	Midwest	South	West
Dec 1989	92	89	245	206
Jun 1990	80	94	233	143
Jul 1990	70	93	238	140
Aug 1990	63	88	238	138
Sep 1990	61	93	216	135
Oct 1990	77	72	210	116
Nov 1990	74	90	212	120
Dec 1990	***73***	***83***	***184***	***122***
Annual Averages:				
1989	90	103	258	202
1990	75	90	222	147
Percent Changes in December 1990 since:				
Dec 1989	-20.7	-6.7	-24.9	-40.8
Nov 1990	-1.4	-7.8	-13.2	1.7

Source: Bureau of Census, Construction Reports, Series C25



Source: Bureau of Census; Real Estate Outlook forecast

Source: Bureau of Census

The new home sales rate remained below the half-million mark during the last three months of 1990. In December, new home sales dropped 33,000 units to 463,000 units. This decrease translated into a 6.7 percent decline from November's level and a 27 percent decline from the level in December 1989. In 1990, new home sales averaged 534,000 units, 18 percent below the level in 1989.

Although the West recorded 1.7 percent growth in new home sales in December, it was the only region that grew in each month of the fourth quarter. New home sales declined in each of the other three regions during December. The South experienced the largest decline in volume, dropping 13 percent from November. Sales dipped 8 percent from November in the Midwest, while falling a modest 1.4 percent in the Northeast.

All four regions experienced double-digit declines in new home sales in 1990 from the year before. The biggest decline was recorded by the West, which fell by 27 percent. The Northeast saw sales slide by 17 percent, while the Midwest and the South were down by 13 percent and 14 percent, respectively.

Sales of new homes are expected to bottom out during the first quarter of 1991, when they are projected to average 472,000 units. With an economic recovery underway by the second half of 1991, lower mortgage rates and rising incomes will provide a renewed stimulus for the demand of new homes. Sales are expected to increase by almost 13 percent in 1992.

Existing Single-Family Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

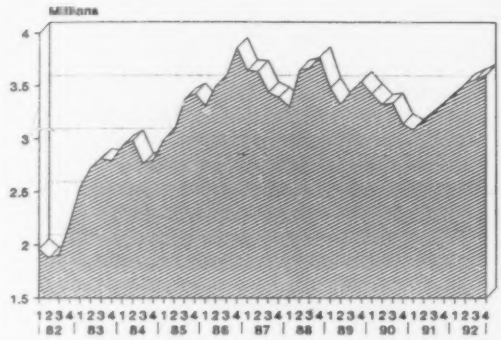
		Mo. Ago % Chg.	Yr. Ago % Chg.
Dec 1989	3,560	0.0	-7.5
Jan 1990	3,470	-2.5	-5.2
Feb 1990	3,400	-2.0	-4.2
Mar 1990	3,400	0.0	-0.9
Apr 1990	3,330	-2.1	-3.2
May 1990	3,300	-0.9	1.5
Jun 1990	3,330	0.9	0.0
Jul 1990	3,330	0.0	-1.5
Aug 1990	3,500	5.1	1.7
Sep 1990	3,170	-9.4	-9.7
Oct 1990	3,050	-3.8	-12.6
Nov 1990	3,150	3.3	-11.5
Dec 1990	***3,220***	***2.2***	***-9.6***
Annual Averages:			
1989	3,467		-2.5
1990	3,304		-4.7

Regional Data

	Northeast	Midwest	South	West
Dec 1989	580	980	1,390	610
Jul 1990	560	930	1,310	530
Aug 1990	520	990	1,400	570
Sep 1990	520	870	1,260	520
Oct 1990	500	820	1,230	490
Nov 1990	510	820	1,310	500
Dec 1990	***490***	***950***	***1,280***	***490***
Annual Averages:				
1989	597	931	1,320	617
1990	521	907	1,316	557
Percent changes in December 1990 since:				
Dec 1989	-15.5	-3.1	-7.9	-19.7
Nov 1990	-3.9	15.9	-2.3	-2.0

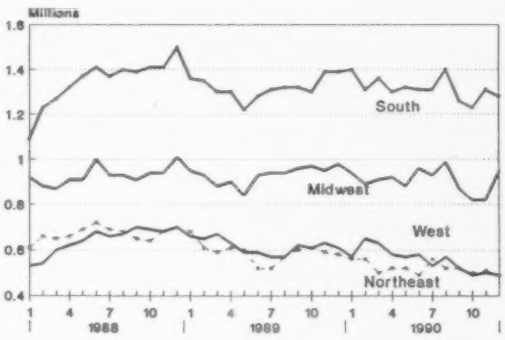
Source: National Association of Realtors,® "Home Sales"

Existing Home Sales



Source: NAR Economics & Research; Real Estate Outlook forecast

Existing Home Sales by Region



Source: NAR Economics & Research

Existing home sales registered a 2.2 percent gain in December, with a sales rate at 3,220,000 units. This represents the second consecutive increase in existing home sales and comes despite declining activity in many key areas of the economy. Robust sales activity in the Midwest, which was up 16 percent, countered modest declines in each of the other three regions in December. In the Northeast, December's sales volume was down by 4 percent. Sales in the South and the West declined by 2 percent in December.

Despite the rebound, the housing market remains weak. Sales in the fourth quarter of 1990 were down 6 percent over sales in the previous quarter. In 1990, sales were 4.7 percent below 1989's sales volume.

Although sales for the year are expected to be down by 3 percent in 1991, the low point is expected to come in the first quarter of 1991. Existing home sales are estimated to fall to 3,085,000 units during the first quarter of 1991. After the first quarter, sales are expected to edge their way back up and will reach 3,163,000 units during the second quarter of 1991. The factors which are expected to boost both housing starts and new home sales in the second half of 1991 -- lower mortgage rates and economic recovery -- will spur sales of existing homes as well. This will carry into 1992, when sales are projected to increase by 10 percent.

Single-Family Home Prices

(In Dollars)

National Data

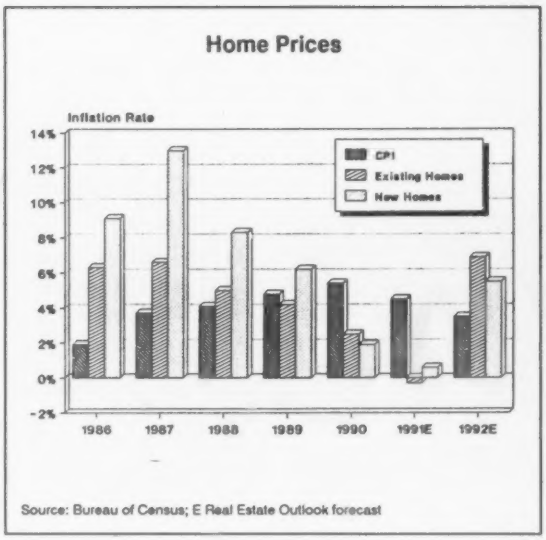
	Median		Average	
	Existing	New	Existing	New
Dec 1989	92,500	125,200	118,100	154,300
Jul 1990	98,300	118,700	122,000	149,800
Aug 1990	97,100	118,400	120,500	144,700
Sep 1990	94,400	113,000	116,700	142,100
Oct 1990	92,900	120,000	115,900	152,700
Nov 1990	91,800	120,000	115,500	145,700
Dec 1990	***91,900***	***133,000***	***114,000***	***163,500***
Annual Averages:				
1989	92,900	120,400	118,000	148,300
1990	95,200	122,700	118,300	150,000
Percent changes in December 1990 since:				
Dec 1989	-0.6	6.2	-3.5	6.0
Nov 1990	0.1	10.8	-1.3	12.2

Regional Data

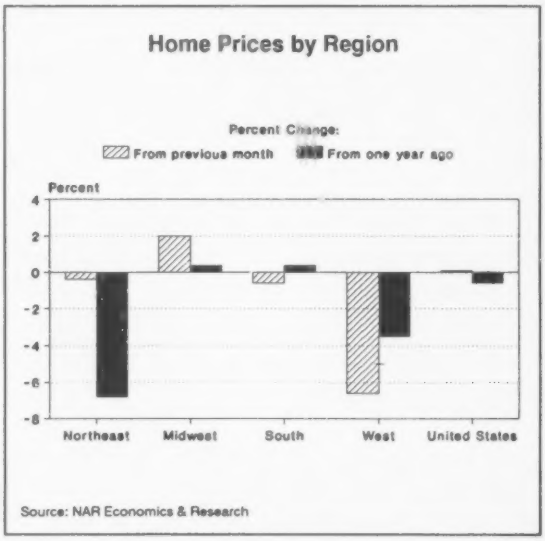
Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
Dec 1989	143,400	72,500	82,700	135,200
Jul 1990	146,900	76,000	88,800	139,700
Aug 1990	145,300	75,300	86,900	140,200
Sep 1990	137,100	74,200	85,900	134,700
Oct 1990	136,200	72,000	83,200	142,000
Nov 1990	134,200	71,400	83,500	139,700
Dec 1990	***133,700***	***72,800***	***83,000***	***130,500***
Annual Averages:				
1989	145,100	71,200	84,400	139,800
1990	141,500	74,100	85,600	139,500
Percent changes in December 1990 since:				
Dec 1989	-6.8	0.4	0.4	-3.5
Nov 1990	-0.4	2.0	-0.6	-6.6

Source: National Association of Realtors,® "Home Sales"



Source: Bureau of Census; E Real Estate Outlook forecast



Source: NAR Economics & Research

The median price of existing homes broke its string of four consecutive declines by growing a scant 0.1 percent in December. The median price currently stands at $91,900, which is 0.6 percent below its year-ago level. After showing no change in November, the median price for new homes jumped 10.8 percent in December. The figure stands at $133,000, up $13,000 from November. With such a large increase, some retreat is projected to occur in the coming months. For all of 1990, the median price of new homes was up by 1.9 percent.

December marked the fifth consecutive month that average prices of existing homes fell. The 1.3 percent decline brought the average down to $114,000. This represents a 6.5 percent decline from its peak of $122,000 in July. In the market for new homes, average prices, like median prices, increased dramatically. The 12.2 percent rise brought the level to $163,500 for December.

A projected decline of only 0.3 percent in 1991 will keep the median price of existing homes close to the 1990 level. As the economy recovers and buyers take advantage of lower mortgage rates, prices are expected to firm. The median price of existing homes is projected to increase by 7 percent in 1992.

Robert D. Barr
Director of Forecasting

Kimberly A. Martin
Research Economist

Forecasting & Policy Analysis

THE REVENUE RECONCILIATION ACT OF 1990:

TAX OUTLOOK FOR THE REAL ESTATE SECTOR

After a nine-month process, the Omnibus Budget Reconciliation Act of 1990 (OBRA) became law in November of last year. Hailed by some as the largest deficit reduction measure but scorned by others as the largest tax increase ever enacted, OBRA contains many significant changes to the federal tax law. The following report provides a short summary of the major federal tax changes affecting the real estate sector contained in Title XI of OBRA known as the Revenue Reconciliation Act of 1990 (RRA).

Tax Rates: Letting Some Air out of the Old "Bubble"

One of the goals of the Tax Reform Act of 1986 (TRA) was tax simplification. TRA collapsed the number of marginal tax brackets from 14 to 2, a 15-percent bracket on the first increments of income earned and a 28-percent bracket on additional income. Between a certain range of taxable income (adjusted gross income minus exemptions and deductions), however, a 5-percent surcharge was added on to the 28-percent tax rate.

The surcharge was a means of phasing out the benefits of the 15-percent bottom tax bracket and the personal exemptions for high-income taxpayers until such benefits were reduced to zero at which point the 28-percent marginal rate applied. Thus, the marginal tax rate for these taxpayers was pushed from 28 to 33 percent, creating a "bubble" in the marginal tax rate.[1]

Under RRA, the 33-percent marginal-tax-rate bubble is eliminated but a new top marginal tax rate of 31 percent has been added to the existing 15- and 28-percent rates. Personal exemptions will still be phased out for upper-income taxpayers, but the phase-out mechanism starts at a different income level from the old phase-out level for each taxpayer. Personal exemptions will be eliminated in steps rather than continuously as they were before RRA.

Beginning in 1991, a new top marginal tax rate of 31 percent starts at the level of taxable income where the old bubble used to start. Single taxpayers will pay 15 percent on the first $20,350 of taxable income; 28 percent on the next $28,950 and 31 percent on the amount above $49,300. Married couples filing jointly will pay 15 percent on the first $34,000 of taxable income; 28 percent on the next $48,150 and 31 percent on taxable income over $82,150. The starting points for each tax bracket will continue to be adjusted for inflation in the future.

By itself, the 31-percent tax rate constitutes a marginal tax rate cut for some taxpayers whose taxable incomes were in the 33-percent bubble range. However, for those taxpayers with incomes beyond the bubble range and subject to a-28 percent marginal tax rate, the marginal tax rate on their income will increase to 31 percent. Because RRA also reinstated the phaseout of personal exemptions and instituted a new limitation on itemized deductions, certain taxpayers could face an effective tax rate higher than 31 percent. Although the 5-percent surcharge creating a bubble in the marginal tax rate was repealed, a smaller marginal-tax-rate bubble will still exist from the creation of the new explicit personal exemption phaseout, leading some to nickname it "Double Bubble" or "Bubble II."[2]

Medicare Hospital Insurance: Cap Increased Nearly 150 Percent

Beginning January 1, 1991, the cap on wages subject to the Medicare Hospital Insurance (HI) payroll tax will increase from $51,300 to $125,000. The HI rates, however, will remain the same, 1.45 percent for each employer and employee and 2.9 percent for self-employed individuals. For example, a taxpayer earning over $125,000 will pay an additional $1,068.65 in HI taxes ($125,000-$51,300 x 0.0145) while the HI taxes of a self-employed individual earning the same income will increase by twice as much at $2,137.30.

Phaseout of Personal Exemptions: Some Win, Some Lose, Large Families Hit Harder

As mentioned above, the new law repealed the old phaseouts of the 15-percent rate and the personal exemptions. However, new phase-out

thresholds for personal exemptions were established. As of January 1991, the deduction for the personal exemptions is reduced by 2 percent for each $2,500 or fraction thereof of adjusted gross income (AGI) exceeding $100,000 for single filers and $150,000 for married couples filing jointly. For married couples filing separately, the reduction is 2 percent for every $1,250 or fraction thereof of AGI above $75,000.

These thresholds will also be indexed for inflation in later years and will be terminated after December 31, 1995. The exemption amount will be completely phased out at an AGI above $222,500 for single filers, $272,500 for married couples filing jointly and $136,250 for married couples filing separately.

Since under RRA, the phase-out range of the personal exemptions on AGI is different from that under TRA, some households will be better off, but others will be worse off. Some analysts argue that, in most cases, the phaseout will start at a higher income level and take effect more gradually than it did previously.[3] Other analysts, however, argue that, for some households with a certain numbers of exemptions, the phaseout will kick in at a lower level of income than that under TRA.[4]

Another interesting point – about this provision is that, before RRA, joint filing by married couples was usually more advantageous than separate filing. However, because of the changes made by RRA, in certain cases, married couples filing separately can reduce the impact of the personal exemptions phaseout. For example, in most cases where both spouses earn different incomes and the lesser-earning spouse's income is equal to or less than $75,000 (threshold of AGI filing separately) while the two combined incomes exceeding $150,000 (the threshold for joint filing), filing separately will reduce the couple's tax liability.[5]

Because personal exemptions are reduced by a full two percent even for *a fraction of* $2,500 of AGI over the threshold (for single and joint filers), a spike in the marginal tax rate is created at each $2,500 step over the threshold. For example, a couple with an AGI of $200,000 will earn $50,000 above the threshold. Since $50,000 divided by $2,500 equals 20, they will lose 40 percent (20x.02) of their personal exemptions of $2,150 each which amounts to $1,720 ($4,300x0.4). However, another dollar of AGI pushes the amount over the threshold to $51,001 resulting in a 42 percent ($50,001 divided by $2,500 equals 20.0004 which will be rounded up to 21 and then multiplied by two) loss of their personal exemptions or about $1,806 ($4,300x0.42). Given that their tax bracket is 31 percent, earning an extra dollar of AGI will translate into about $26 higher tax liability ($1,806x0.31 - $1,720x0.31).

The percentage loss in the personal exemptions will apply to each exemption. Thus, larger families claiming greater numbers of exemptions will lose a larger amount than smaller ones. Following the above example, a couple with $200,000 of AGI and three children would lose 40 percent of their personal exemptions totaling $10,750 or $4,300 ($10,750x0.4). As a result of this provision, the couple would owe an additional $1,333 (0.31x4,300) in taxes. In comparison, the same couple without children would owe an additional $533 (0.31x1,720). Thus, given the same AGI, larger families will lose a larger amount of their personal exemptions than smaller families.

"Floor" on Itemized Deductions: Another Sign of Erosion of Mortgage Interest Deductions

RRA's provision limiting itemized deductions, known as the "Pease plan" after its drafter, signals another erosion of deductions for homeowners. The targets of this deduction-recapture provision are mortgage interest deductions, state and local income and personal property taxes and charitable contributions. It does not apply to deductions for medical expenses, investment interest and casualty, theft, and wagering losses. Unlike the provision in the Budget Reconciliation Act of 1987 placing a limit on the mortgage interest deduction on acquisition indebtedness for principal residences of $1,000,000, the 1990 provision will affect a considerably larger number of taxpayers, about 3.6 million households.[6]

The provision calls for a reduction in the non-exempt itemized deductions in the amount of 3 percent of AGI over $100,000 for single filers and married couples filing jointly and over $50,000 for married couples filing separately. The amount of AGI that will trigger the loss in itemized deductions will be indexed annually for inflation in the future and will be effective until December 31, 1995. The reduction of non-exempted itemized deductions could result in a loss of up to 80 percent of the amount of such deductions so that all taxpayers will

get at least 20 percent of the itemized deductions they report. For example, a joint filer with AGI of $150,000 and non-exempt itemized deductions of $30,000 will lose $1,500 worth of such deductions ($150,000-$100,000 x.03). With a floor of $1,500, he will not be able to deduct the first $1,500 of his itemized deductions and therefore could deduct only $28,500 ($30,000-$1,500) from his AGI to derive his taxable income.

Some analysts note that this provision represents an indirect way to boost the top marginal rate for the upper-income taxpayers because it is roughly equivalent to a one-percent marginal tax rate increase (three percent times the new 31-percent top marginal tax rate).[7] However, in practice, the provision will be more complicated than a simple rate increase and also will give an unintended and unjustified benefit to the small number of high-income taxpayers who have little or no itemized deductions.[8] Thus, the provision raised the issue of tax equity in that taxpayers who have larger amount of deductions are taxed at a higher rate than those similarly situated taxpayers with small amount or no deductions.

Capital Gains:
Maximum Rate of 28 Percent, But Effective Rate Could be Higher

TRA treated capital gains income as ordinary income and therefore capital gains were taxed as such. In effect, capital gains could be taxed as high as 33 percent if they were realized by taxpayers in the bubble range. Beginning January 1991, capital gains will be subject to a maximum rate of 28 percent even if the taxpayers were in the 31-percent marginal tax bracket. The addition of a top 31-percent marginal tax rate coupled with the return to different rates for capital gains and ordinary income will reduce simplicity intended in the 1986 tax law somewhat.[9]

Although the maximum rate was set at 28 percent for capital gains, the phaseout of the personal exemptions and the limitation on itemized deductions could cause the effective tax rate to be higher than 28 percent for some taxpayers. This is because capital gains are a component of AGI. An increase in AGI will cause taxpayers to lose more of their itemized deductions which will increase their taxable income by more than the increase of the capital gains. Thus, even though the tax rate on the capital gains income is 28 percent, the fact that the increase in the taxable income is more than the increase in capital gains through the loss of the itemized deduction will cause the tax liability to increase by more than 28 percent.

The following Sample Tax Calculation table compares the increase in tax liability of two couples -- middle-income and high income -- as their capital gains income increases by one dollar. It shows how the effective tax rate on the capital gains income can be 28 percent for some but can exceed 28 percent for others.

Couples A and B, each filing jointly, have $20,000 of capital gains income, $30,000 of itemized deductions and two personal exemptions. The only thing that differs is their ordinary incomes, $60,000 for A and $157,000 for B. Since A's AGI is below both the level of AGI triggering the reduction in the itemized deductions and the threshold of personal exemptions phaseout, earning an extra dollar of capital gains, other things being constant, will increase their taxable income by one dollar and thus their tax liability by 28 cents or 28 percent, the maximum tax rate on capital gains.

For couple B, however, earning an extra dollar of capital gains will trigger a loss of three cents in their itemized deductions (line 6) and therefore increase their taxable income by one dollar and three cents (line 11). Although the dollar increase in the capital gains will increase capital gains tax liability by 28 cents, their ordinary-income tax liability will also increase as well resulting in a total increase in their tax liability by almost 29 cents.

Alternative Minimum Tax:
3-Point Increase Parallels Top Marginal Tax Rate Increase

The alternative minimum tax (AMT) was designed to extract taxes from high-income taxpayers and corporations who might have shielded their income from the regular income tax either by receiving various types of tax-exempt income or obtaining large deductions offsetting taxable income. In 1991, the individual AMT rate will increase from 21 percent to 24 percent. The justification for the increase is to match the increase in the explicit top marginal tax bracket from 28 percent to 31 percent.

Sample Tax Calculation
Comparing Effective Capital Gains Rate for Two Income Levels
for an Additional Dollar Increase in Capital Gains
(Joint return, two exemptions, 1991 rates)

	Couple A		Couple B	
(1) Ordinary Income	$60,000.00	$60,000.00	$157,000.00	$157,000.00
(2) Capital Gains	$20,000.00	$20,001.00	$20,000.00	$20,001.00
(3) Adjusted Gross Income (1)+(2)	**$80,000.00**	**$80,001.00**	**$177,000.00**	**$177,001.00**
(4) Itemized Deductions	$30,000.00	$30,000.00	$30,000.00	$30,000.00
(5) Percent of Itemized Deductions Allowable	100.00%	100.00%	92.30%	92.30%
(6) Allowable Itemized Deductions (4)x(5)	**$30,000.00**	**$30,000.00**	**$27,690.00**	**$27,689.97**
(7) Number of Personal Exemption	2	2	2	2
(8) Amount of Personal Exemption	$2,150.00	$2,150.00	$2,150.00	$2,150.00
(9) Percent of Personal Exemption Allowable	100.00%	100.00%	76.00%	76.00%
(10) Allowable Personal Exemptions (7)x(8)x(9)	**$4,300.00**	**$4,300.00**	**$3,268.00**	**$3,268.00**
(11) Taxable Income (3)-(6)-(10)	**$45,700.00**	**$45,701.00**	**$146,042.00**	**$146,043.03**
(12) Taxable Income excluding Capital Gains	$25,700.00	$ 25,700.00	$126,042.00	$126,042.03
Ordinary Income Tax Liability				
(13) 15%	$3,855.00	$3,855.00	$5,100.00	$5,100.00
(14) 28%	$0.00	$0.00	$13,482.00	$13,482.00
(15) 31%	$0.00	$0.00	$13,606.52	$13,606.53
Capital Gains Tax Liability				
(16) 15%	$1,245.00	$1,245.00	0.00	0.00
(17) 28%	$3,276.00	$3,276.28	$5,600.00	$5,600.28
(18) Total Tax Liability (12)+(13)+(14)	**$8,376.00**	**$8,376.28**	**$37,788.52**	**$37,788.81**
(19) Effective Marginal Tax Rate		28.00%		28.93%

Motor Fuel and Gas Tax:
Rising Costs for Builders, Developers And Real Estate Agents

Before RRA, the Federal excise taxes which was imposed on gasoline and special motor fuels and diesel used in highway transportation were scheduled to expire after September 30, 1993. RRA extended these taxes through September 30, 1995 and also increased them by five cents per gallon.